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MERGERS & ACQUISITIONS

The narrowing window for the 'merger tax' in M&A stockholder lawsuits

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Recent court decisions reflect a significant shift in the treatment of the so-called 'merger tax' – lawsuits filed by stockholders following the public announcement of a merger or acquisition of a public corporation, which allege that the target's directors breached their fiduciary duties by agreeing to sell the corporation for an unfair price. In many such lawsuits, filed on behalf of a putative class of the target's stockholders, the plaintiffs would agree to settle their claims on a 'disclosure-only' basis early in the litigation through the corporation making additional disclosures pertaining to the transaction and covering the fees of the plaintiffs' counsel up to a cap.

The frequency of such lawsuits rose dramatically from 2005 to 2014 before beginning a sharp decline. One study conducted by professors at the University of California at Berkeley and the University of Notre Dame found that approximately 40 percent of public transactions incurred such litigation in 2005, compared to approximately 90 percent in 2011. A separate study conducted by Cornerstone Research found that the litigation rate remained

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consistently above 90 percent from 2011 to 2014 and that such lawsuits were common across deal size as well.

For instance, in 2012, 93 percent of mergers and acquisitions valued over $100m and 96 percent of such transactions valued over $500m were challenged, figures that remained virtually unchanged in 2014. The proportion of lawsuits settled on a 'disclosure-only' basis increased significantly as well, from approximately 45 percent in 2005 to 76 percent in 2012 and 80 percent in 2014. However, a follow-up report published by Cornerstone Research in August 2016 found that the proportion of M&A transactions valued over $100m that were the subject of litigation had declined from 93 percent in 2014 to 64 percent in 2016, marking the first time that the percentage had declined below 90 percent since 2009.

This drop reflects recent developments suggesting that courts in Delaware and in other jurisdictions have grown sceptical of 'disclosure-only' settlement agreements. In January 2016, the Delaware Chancery Court issued its landmark decision in *In re Trulia, Inc. Stockholder Litigation*, which involved the $3.5bn stock-for-stock merger of Zillow Group, Inc. and Trulia, Inc. The plaintiffs, a putative class of Trulia stockholders, sought a preliminary injunction to enjoin the stockholder vote to approve the merger, asserting breach of fiduciary duty claims against the Trulia directors and related aiding-and-abetting claims against Trulia and Zillow. The plaintiffs alleged material misstatements in the proxy statement distributed by Trulia to its stockholders.

Following expedited discovery, the plaintiffs and the defendants entered into a memorandum of understanding to settle the litigation, pursuant to which the plaintiffs agreed to withdraw their preliminary injunction motion and to grant the defendants a release of all known and unknown claims relating to the transaction. In consideration for such withdrawal and release, the defendants agreed to provide certain supplemental disclosures relating to the fairness opinion provided by Trulia's financial adviser and to not oppose the request of the plaintiffs' counsel for fees up to a cap. Subsequently, the stockholders voted overwhelmingly to approve the merger, and the plaintiffs and the defendants submitted their proposed settlement agreement to the Court for approval.

The Court rejected the proposed settlement agreement in light of the "rapid proliferation and current ubiquity of deal litigation, the mounting evidence that supplemental disclosures rarely yield genuine benefits for stockholders, the risk of stockholders losing potentially valuable claims that have not been investigated with rigor, and the challenges of assessing disclosure claims in a non-adversarial settlement process". Instead, the Court found that the "optimal means" by which disclosure claims should be adjudicated is "outside the context of a proposed settlement agreement so that the Court's consideration of the merits of the disclosure claims can occur in an adversarial process where the defendants' desire to obtain a release does not hang in the balance".

As a result, the Court signalled its intent in the future to be "increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the 'give' and the 'get' of such settlements". In particular, the Court explained that any disclosure settlement agreement should address "a plainly material misrepresentation or omission, and the subject matter of the proposed release [should

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be] narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process". Applying this standard, the Court rejected the proposed settlement agreement, finding that the supplemental disclosures provided therein did not provide a material benefit to stockholders and so did not constitute adequate consideration for the release of claims obtained by the defendants. On this basis, the Court determined that the proposed settlement agreement was neither fair nor reasonable to Trulia's stockholders.

In *Trulia*, the Delaware Chancery Court expressed its "hope and trust that [its] sister courts will reach the same conclusion if confronted with the same issue". This prediction has largely been proven true, as the decision has been cited favourably by state and federal courts in California, Connecticut, Illinois, New Jersey, North Carolina and Texas as of this writing, and as the follow-up Cornerstone Research report indicates, M&A litigation has fallen significantly in its wake. In its follow-up study, Cornerstone Research attributed this precipitous decline specifically to *Trulia* and its adoption in other jurisdictions.

In addition, anecdotal evidence suggests that plaintiff-stockholders are more frequently making requests to inspect the books and records of corporations pursuant to Section 220 of the Delaware General Corporation Law in connection with M&A litigation, which may suggest that, in light of *Trulia*, plaintiffs are seeking to use the 'tools at hand' to attempt to develop claims to litigate rather than to quickly settle on a 'disclosure-only' basis. Indeed, a March 2017 article authored by researchers at the University of California at Berkeley, the University of Pennsylvania, Vanderbilt University and the US Securities and Exchange Commission quantified the extent to which *Trulia* has raised the bar in Delaware, identifying, among other changes, "an overall reduction in the size of attorneys' fee awards" and "higher dismissal rates for cases generally" in connection with M&A litigation.

Nonetheless, *Trulia* has not been embraced uniformly across all jurisdictions. Mostly notably, in February 2017, in *Gordon v. Verizon Communications, Inc.*, an appellate court in New York announced a different approach in reversing a lower court's rejection of a 'disclosure-only' settlement agreement in connection with the sale of Vodafone Group plc's minority stake in Cellco Partnership, Inc. to Verizon for $130bn in cash and stock. The settlement agreement at issue would have required Verizon to: (i) provide its stockholders with supplemental disclosures; (ii) obtain a fairness opinion from an independent financial adviser if the corporation entered into certain material transactions during the subsequent three years and; (iii) not oppose the fees and expenses application of the plaintiffs' counsel up to a cap.

The *Gordon* Court found that the proposed settlement agreement was in the best interests of each of the putative class of plaintiff-stockholders and the corporation because the incremental disclosures were "of some benefit" to the stockholders and because the fairness opinion requirement provided a "prospective corporate governance reform" from which Verizon stockholders would benefit in the future. Most recently, in March 2017, in *Roth v. Phoenix Companies, Inc.*, another New York court approved a similar proposed settlement agreement and noted in a footnote that the "some benefit" test announced in *Gordon* "cannot be viewed as anything other than an

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outright rejection of *Trulia*'s 'plainly material' standard".

It remains to be seen whether *Trulia* or *Gordon* will become the prevailing standard for evaluating 'disclosure-only' settlement agreements in M&A litigation. As the doctrine develops, however, corporations interested in forestalling M&A litigation may wish to consider incorporating 'internal affairs' forum selection bylaws that select Delaware (or another jurisdiction that has adopted the *Trulia* standard) in their constituent documents. The *Trulia* Court itself responded to the worry that "enhanced judicial scrutiny of disclosure settlements could lead plaintiffs to sue fiduciaries of Delaware corporations in other jurisdictions in the hope of finding a forum more hospitable to signing off on settlements of no genuine value" – by explaining that it is "within the power of a Delaware corporation to enact a forum selection bylaw to address this concern".

Indeed, in its opinion of August 2016 pertaining to *In re CytRx Corp. Stockholder Derivative Litigation*, a federal court in California expressed scepticism over the parties' attempt to settle a claim similar to that of *Trulia* even though the target corporation had a Delaware forum selection bylaw. Noting that the Delaware Chancery Court "has gained a reputation for rejecting shareholder class action and derivative settlements that do not have a monetary component yet include a broad release of claims and an award of attorneys' fees," the court found it "reasonable to infer that a motivation" for seeking to settle in California "may be to avoid a forum that reviews critically the general type of settlement proposed by the Parties here". Practitioners would be well-served by considering how receptive a forum will be to a proposed settlement of M&A litigation in the post-*Trulia* world. ■

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